



MARCH ASSET ALLOCATION NOTE

REFLATION, RISING RATES, AND AN EQUITY MARKET ROTATION

After reviewing the economic and market environment, Highland offers the following comments on the current landscape:

Reflections on a Strange Year

Twelve months ago, domestic confirmed COVID cases still numbered in the hundreds. Outbreaks in China and Italy felt frightening, but remote.

That complacency was punctured on March 11, 2020, when the NBA paused its regular season. That freeze, in response to Utah Jazz center Rudy Gobert testing positive for COVID-19, was one of the first big foreshocks presaging the disruptive impact the pandemic would have on all of our lives. Two weeks later businesses were closed, schools were shut down, and lockdowns were ramping up.

Today, with vaccination campaigns representing a clear light at the end of the tunnel, we're taking this anniversary as a prompt to look back on a very strange year.

The last 12 months posed significant challenges. However, they weren't all bad. One team member relished getting to spend more time with his son before he left for college. Another got a puppy. A third discovered a love of baking. As we prepare for a return to normalcy later this year, we're hoping to carry some of those changes forward into 2022 and beyond. And we're not the only ones.

While we're generally constructive on return to normal and reopening themes, we're also monitoring the lasting impacts of this pandemic: From the accelerated adoption of work from home to the ongoing sea change in Congress's approach to fiscal stimulus, we think some of the macro and market effects of the last 12 months could have staying power. Unpacking the investment implications of those shifts could be a key focus for our team long after vaccination campaigns are complete.



TRANSFORMING PORTFOLIOS. ADVANCING MISSIONS.

Highland Associates, Inc. is an institutional investment advisor headquartered in Birmingham, Alabama. Highland was founded specifically to help develop, implement and maintain investment management programs for institutions. We serve a national client base of investors including not-for-profit healthcare organizations, foundations, endowments, defined benefit plans and defined contribution plans. Please visit the website at www.highlandassoc.com to learn more.

HIGHLAND ASSOCIATES
2545 HIGHLAND AVENUE SOUTH
SUITE 200
BIRMINGHAM, ALABAMA 35205
P. 1-800-405-7729 / (205) 933-8664
F. (205) 933-7688

- BIRMINGHAM
ST LOUIS
NASHVILLE

Macro Outlook and HDI Update

Our market outlook is increasingly favorable. This is consistent with our Highland Diffusion Index (HDI) framework, which shows the following:

- ▲ Monetary policy remains accommodative.
- ▲ The yield curve remains upward sloping across its term structure, indicating the market is pricing in future growth.
- ▲ Credit spread tightening and equity market momentum remain positive as investors remain hungry for the return from risk assets.
- ▲ While economic indicators including labor market conditions deteriorated due to worsening outbreaks earlier this winter, those challenges could prove short-lived.

Moreover, recent news on the fiscal and public health fronts supports our constructive outlook:

- ▲ The pandemic is waning. The number of COVID patients being treated in U.S. hospitals has plunged from over 130,000 at its January peak to roughly 50,000 in late February.

This trend could accelerate as vaccine production increases. Here in the U.S., we're optimistic vaccination campaigns will support a widespread reopening this summer.

- ▲ Congress has enacted a ~\$1.9T stimulus package which includes \$1400 economic impact payments, extended pandemic unemployment assistance, and state fiscal aid. Funding from that package should start to flow out to households later this month.

This combination of renewed fiscal support and falling case counts could put the economic recovery back on track over the next couple months, buttressing our reflationary growth outlook.

Reflation and Rising Rates

U.S. equity markets have long priced in a healthy recovery. However, treasury markets have been slower to reflect that outlook. Today, treasury markets are starting to play catch-up with equities and other risk assets.

Interest rates accelerated higher last month: 10-year treasury yields have climbed from ~1.1% in late January to ~1.6% in early March. The recent treasury sell-off was a testament to investors' growing confidence that vaccination campaigns and fiscal stimulus could propel a rapid economic recovery, and a relatively quick liftoff from the zero-lower bound.

We came into February well positioned for rising rates:

- ▲ We reduced Treasury Inflation-Protected Securities (TIPS) exposure, while adding to listed real estate (REITs) in January. That tilt away from TIPS was additive as real rates sold off last month.
- ▲ We took off our core fixed income over enhanced cash tilt last March, when 10-year yields first fell below 0.6%. That decision to reduce duration has helped protect portfolios from rising rates.

As rates rise, we will continue to monitor duration exposure. We're also positioning around these trends in clients' equity portfolios.

Positioning for a Rotation in Equity Leadership

Last month we highlighted our decision to close out our domestic equity tilt and spoke to our growing focus on small and mid-cap managers here in the U.S. Today, we're continuing to shift equity exposure by favoring emerging market (EM) equities – including Chinese, South Korean, and Brazilian stocks – over developed market (DM) equities.

We're constructive on emerging markets for three reasons:

- ▲ EMs should benefit from synchronized early cycle growth and a recovery in global trade. Rebounding commodity prices could also be positive for EM equities.
- ▲ Low valuations and attractive economic fundamentals should drive healthy returns for EM allocators over a strategic horizon.
- ▲ Our momentum-based relative strength indicator framework increasingly favors EM equities.

Moreover, currency effects could contribute to EM returns near term, as the dollar tends to weaken relative to EM currencies in early cycle environments. Any loosening of U.S. trade policies under the Biden administration could also bolster EM growth prospects.

Meanwhile, here in the U.S., we're still finding opportunities with small and mid-cap managers.

Our focus on small and mid-cap U.S. managers ties into broadening leadership and reflation themes. If the U.S. recovery accelerates, less loved styles and sectors could continue to see tailwinds, while recent winners could lag.

That focus also dovetails with recent rising rate trends. Large-growth stocks are more sensitive to shifts in the discount rates used to value their future cash flows than smaller, more cycle exposed value stocks. That sensitivity has been on display recently, as growth skewed indices like the NASDAQ 100 have underperformed during stretches of rising rates. If rates continue to rise, tilting away from large-growth stocks could be rewarded.

Over the next couple months, we'll continue to look for ways to capitalize on this prevailing market regime.

HIGHLAND ASSOCIATES

2545 HIGHLAND AVENUE SOUTH
 SUITE 200
 BIRMINGHAM, ALABAMA 35205
 P. 1-800-405-7729 / (205) 933-8664
 F. (205) 933-7688

-
- ▲ BIRMINGHAM
 - ▲ ST LOUIS
 - ▲ NASHVILLE

IMPORTANT DISCLOSURES: The information provided herein is for informational purposes only and is intended to report on various investment views held by Highland Associates. Opinions, estimates, forecasts, and statements of financial market trends are based on current market conditions that constitute our judgement and are subject to change. The information herein was obtained from various sources. Highland does not guarantee the accuracy or completeness of such information provided by third parties. The information is given as of the date indicated and believed to be reliable. While Highland has tried to provide accurate and timely information, there may be inadvertent technical or factual inaccuracies or typographical errors for which we apologize. The information provided herein does not constitute a solicitation or offer by Highland or its affiliates, to buy or sell any securities or other financial instrument, or to provide investment advice or service. Nothing contained herein should be construed as investment advice or a recommendation to purchase or sell a particular security. Investing involves a high degree of risk, and all investors should carefully consider their investment objective and the suitability of any investments. Past performance is not indicative of future results. Investments are subject to loss.